NATIONAL FORECAST DESCRIPTION

The Forecast Period is the Third Quarter of 2003 through the Fourth Quarter of 2007

The long, frustrating wait for better times may be over. It appears the U.S. economy completed its protracted turn away from the doldrums into more prosperous waters during the second half of 2003. Technically, the U.S. economic recovery began about two years ago. Indeed, real GDP has grown since the last quarter of 2001. More specifically, the National Bureau of Economic Research pinpoints the recession's end as November 2001. Although the economy has been moving forward since then, up until recently, it has not felt like much of a recovery. The reason for this is the absence of two important parts of a typical recovery: the lack of business investment and the lack of jobs.

Most recessions are caused by the decline in its largest segment, consumer spending. For example, during the 1990-91 recession real consumer spending retreated 1.3% over three quarters. In contrast, real consumer spending expanded during the 2001 recession, and has continued growing since it ended. So, unlike in most recessions, real consumer spending was not an issue in the 2001 recession.

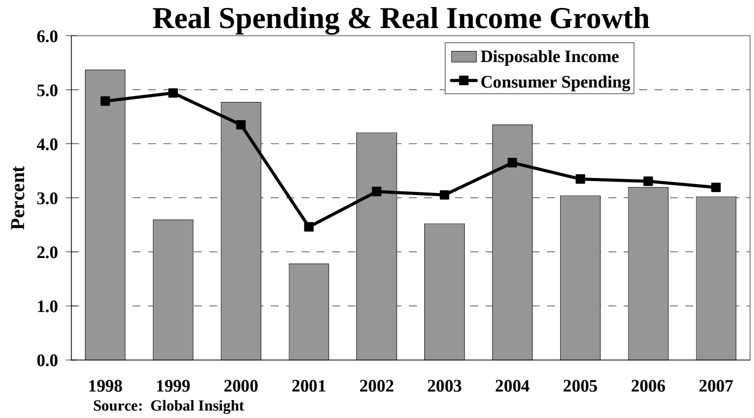
The real culprit in the 2001 recession was the collapse in real business investment. This sector's quick and severe reversal translated into havoc in the overall economy. Real business investment increased an average of 9.9% annually from 1992 to 2000. Much of this growth reflected the strong showing of the equipment and software component. This being the case, it is no surprise business investment collapsed when spending on equipment and software retreated. However, this situation improved last year, as investment began to expand once again. The good news is conditions are ripe for continued growth over the forecast period. First, previous high-tech investments are becoming obsolete. Second, any equipment purchases will be helped by low interest rates. Third, improving corporate profits will make it easier to pay for equipment. Fourth, generous tax treatment for newly acquired equipment will also tilt the scales in favor of additional investment. Fifth, the improving stock market will give companies another option for financing their equipment needs. It should be noted, however, that even with all these factors in its favor, real business investment is not likely to expand as it did in the 1990s. There is a global excess of manufacturing capacity, and this will limit future investments.

The most painful legacy of the recovery has been the lack of jobs. As recently as the summer of 2003, the nation's unemployment rate was climbing. Since then, it has been declining gradually. The improving job situation will help consumer confidence, and will play a big role in the economy's future. Part of the reason consumer spending did not decline during the recession was well-timed fiscal and monetary policies. Two rounds of federal income tax rebate checks helped keep Americans spending, as did low interest rates. The impacts of these policies will decreases over time, but stronger investment and job growth should keep the economy moving forward. One sign the labor market is ripe for a recovery is soaring productivity. Productivity rose a remarkable 7.0% in 2003's second quarter and an astounding 8.1% in its third quarter. Productivity typically surges during a recovery before employment restarts. This is because businesses use resources other than labor to meet growing demand. At some point, however, employers exhaust other alternatives and must add employees.

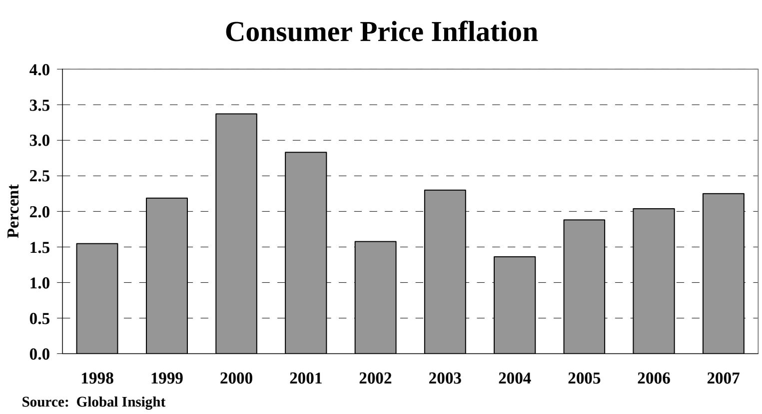
The two missing pieces of the economic recovery, investment and jobs, have finally fallen into place. By doing so they complete a picture that suggests the U.S. economy will enjoy stronger growth over the forecast period than it did in the first three years of this decade.

SELECTED NATIONAL ECONOMIC INDICATORS

Consumer Spending: True to form, American consumers have continued to spend despite the soft job picture. This has been a trademark of the current recovery. A quick look back shows real consumer spending has, in fact, expanded in every quarter since the second quarter of 1991. This is unusual because most recessions are the result of consumers curbing their spending. For example, real consumer spending shrank in both the last quarter of 1990 and the first quarter of 1991, which were also the two weakest quarters for real GDP during the 1990-91 recession. This was no coincidence. However, more recently, consumers with means have showed they will not pass up a bargain. Durable goods accounted for a huge part of spending by growing faster than overall consumer spending recently. Lured into showrooms by generous financial incentives, many Americans left with new vehicles, causing sales to average about 17 million units annually for the three-year period from 2000 to 2002. New vehicle sales are expected to drop slightly to 16.6 million units this year. The strong housing market bolstered sales of other durable goods, such as major appliances. The combination of housing price appreciation and low interest rates has provided the means for consumers to indulge themselves despite the anemic job picture. This occurred in several ways. Low interest rates lead to a rash of refinancing. Some homeowners cashed out and spent some of their equity. The lower interest rates also dropped monthly mortgage payments, freeing up additional cash. Others took out home equity loans, which provided an easily drawn on cash reservoir. Last summer consumers received a windfall to propel further spending. Provisions of the Jobs and Growth Tax Reconciliation Act of 2003 cut income tax withholdings by a $45.8 billion annual rate during the third quarter of 2003. Additionally, advance payments of the child tax credit boosted disposable income by $55.4 billion, bringing the total tax cut to a $101.2 billion annual rate during the 2003 summer quarter. The goal of these cuts was to get money into the hands of consumers to spend, and consumers obliged. Real consumer spending surged at a 6.6% annual rate in the third quarter of 2003—its strongest showing in six years. Of course, this was a one-time impact, so spending growth is not expected to remain that high. However, it is not expected to collapse either. For the first time in several years merchants have high expectations for Christmas. It has been estimated that nominal retail sales excluding autos will improve 6% compared to last year. On an annual basis, real spending less autos should grow 3.4% during the last quarter of 2003. Real spending growth is expected to continue after 2003 thanks to stronger job growth. Specifically, real spending is predicted to advance 3.7% in 2004, 3.3% in 2005, 3.3% in 2006, and 3.2% in 2007.



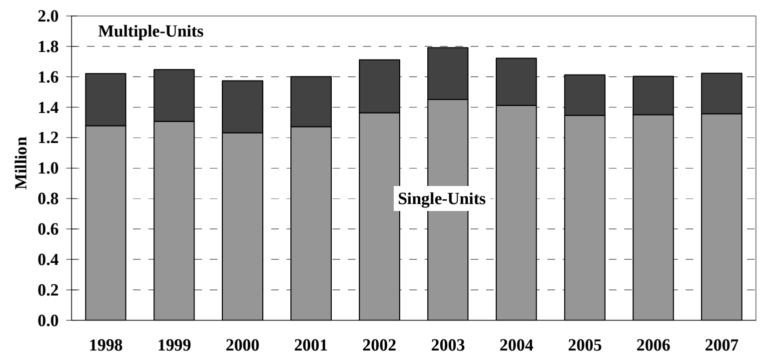
Inflation: The U.S. economy is expected go from relative price stability to modest inflation over the forecast period. Inflation has been scarce although the economy is expanding. Top-line inflation measures such as the core consumer price index and core chained personal consumption deflator showed year-over-year inflation was running about 1.0% last September. Assuming measurement bias is about 1.0%, actual inflation is virtually



nonexistent. There are a couple of reasons inflation has been so tame. First, commodity prices have grown just fractionally over the past year. Second, labor costs have been contained thanks to the phenomenal productivity growth. Eventually, productivity should slow, and this will put pressure on compensation, which in turn will fuel inflation. However, this will come down the road. In 2004, the consumer price index is expected to drop below 2.0% growth thanks to falling energy prices. Inflation will accelerate slightly thereafter, but should remain modest by historical standards. The slow rise in core inflation is caused by a number of factors, the most important being a stronger economy. The latter, in particular, will provide a better balance in markets and allow companies greater pricing leverage, although this will take time to develop due to the large amount of unused capacity available. The projected productivity growth will help keep unit labor cost increases just under 2.0% per year. The consumer price index is forecast to increase 2.3% in 2003, 1.4% in 2004, 1.9% in 2005, 2.0% in 2006, and 2.2% in 2007.

Housing: The housing sector has been an unusual bright spot during the recession. More than once, this sector's strength has caught analysts by surprise. The housing is usually soft during recessions because consumers resist making such an important financial commitment during periods of economic uncertainty. This was indeed the case in the 1990-91 recession. During that slowdown U.S. housing starts plunged nearly 40% to 1,000,000 units. However, the housing industry broke with this tradition in recent years. While housing starts did decline in 2000, the 4.8% drop was much smaller than the nearly 40% plunge in 1990-91. Part of the reason for the smaller drop was the impact of the softer economy was dampened by low interest rates. These low interest rates also help explain why housing recovered so quickly despite the soft job market. For example, there were 1.6 million housing starts in 2001, 1.7 million units in 2002, and an estimated 1.8 million in 2003. The expected rise in mortgage interest rates will take its toll, but the impact will be relatively minor. This is because the declines are from such high levels. Specifically, housing starts are expected to decline in each year through 2006 then increase in 2007. Of course, the housing sector could continue to defy traditional expectations. Global Insight recently reported in the fall that there were no signs of downward pressure on the housing market due to a backlog of completed houses waiting for owners. In fact, there was only a 3.7-month supply of single-family homes, which is near the record low of a 3.5 months supply. It is interesting to point out that the U.S. homeownership rate has improved markedly over the last few years. The Census Bureau reported the homeownership rate reached a record high of 68.4% in the third quarter of 2003. This was up 1.4 percentage points from the previous five years and 3.7 percentage points over the previous decade. In the previous ten years, homeownership rates had been flat.

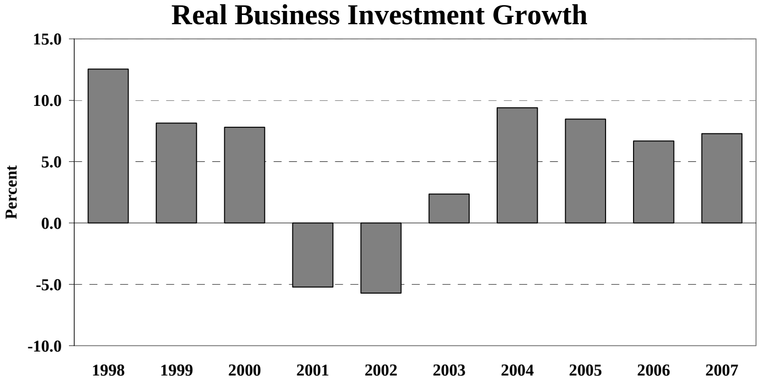
U.S. Housing Starts



Source: Global Insight

Business Investment: An important missing piece to the recovery was found when business fixed investment began expanding last summer. The importance of the investment turnaround cannot be overstated because the collapse of business investment contributed heavily to the 2000 recession. This drop was especially painful because through most of the 1990s business investment was an

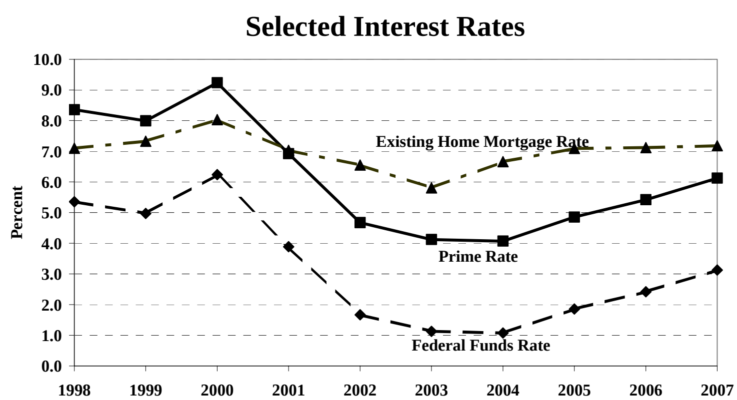
Real Business Investment Growth



Source: Global Insight

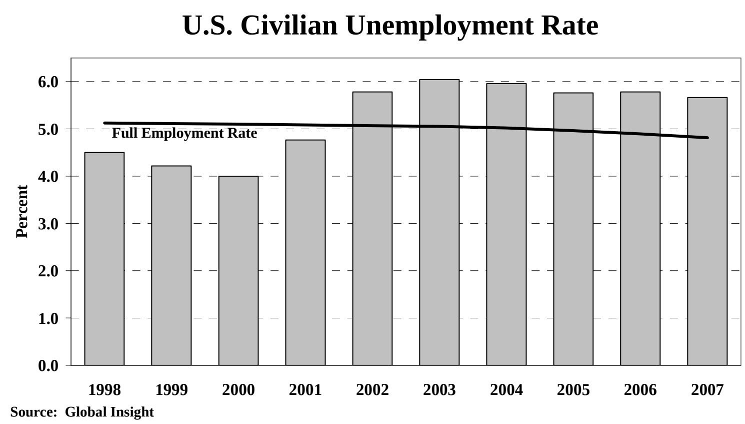
important growth engine that out performed the overall economy. A brief review puts this in perspective. Real business investment increased in every year from 1992 to 2000. An amazing 9.9% annual growth rate caused the level of real business investment to more than double over this nine-year period. Business investment expanded by nearly 13% in 1998 alone. Much of this growth reflected the strong showing of its equipment and software component. Fueled by Y2K concerns, the Internet, and the Telecommunications Act of 1996, real equipment and software investment eclipsed overall business investments' torrid pace. This being the case, it is no surprise business investment collapsed when spending on equipment and software retreated. Specifically, real business investment declined 5.2% in 2001 and 5.7% in 2002 and equipment and software spending slid 6.4% in 2001 and 1.7% in 2002. Over the forecast period, business investment's fate will be tied to its equipment and software component. The good news is conditions are ripe for this component to expand over the forecast period. First, high-tech equipment becomes obsolete very quickly. Since the last round of investment was about three years ago, equipment is due for replacement. Second, any equipment purchases will be helped by low interest rates. Third, improving corporate profits will make it easier to pay for equipment. Fourth, generous tax treatment for newly acquired equipment will also tilt the scales in favor of additional investment. Fifth, the improving stock market will give companies another option for financing their equipment needs. It should be noted, however, that even with all these factors in its favor, real business investment is not likely to expand as it did in the 1990s. This is because the 1990s growth was an anomaly. While that decade's strong growth was appreciated, it was not sustainable, and, therefore, probably not repeatable. Real business investment is forecast to increase 2.4% in 2003, 9.4% in 2004, 8.5% in 2005, 6.7% in 2006, and 7.3% in 2007. On the other hand, real investment on equipment and software should rise 5.2% in 2003, 11.5% in 2004, 8.6% in 2005, 7.1% in 2006, and 7.4% in 2007.

Financial: Could the Federal Reserve do better? With regard to inflation, this is the question the Federal Reserve has been asking itself for some time. This longstanding discussion on price stability has centered on inflation targeting—that is, an explicit commitment to meet a publicly state numerical target (or range) within a given time frame. There is some evidence that a formal inflation target does help anchor inflation expectations, thereby making the job of monetary policy easier. It does so chiefly by improving the transparency of monetary policy, thereby shortening the lag between policy actions and real outcomes. In short, targeting is believed not only to help lower inflation, but also keep inflation and output more stable. Opponents of targeting worry that establishing a target would unnecessarily restrict the central bank's policy choices. Discussions at the Federal Reserve are taking on greater interest, both because Chairman Greenspan is their chief opponent and because of his planned departure in 2006. Until then the nation's central bank will be on the look out for rekindling inflation. In this forecast the Federal Reserve is assumed to hold off tightening until the end of this year. There are two reasons for the Federal Reserve's patience. First, the worldwide excess of manufacturing capacity is keeping inflation low. Second, the Federal Reserve does not like to be accused of playing politics, so it traditionally avoids making policy changes close to a general election After the election, the federal funds rate is assumed to rise gradually, going from 1.0% in the third quarter of 2004 to 3.5% by the last quarter of 2007.



Source: Global Insight

International: One of the laggards during the recovery, the international trade sector, should show some signs of improvement during the forecast period. Net exports, which is simply exports less imports, serves as an accurate barometer of this sector's performance. In recent years the trickle of exports from the U.S. has been swamped by the flood of imports into this country, causing the real net export deficit to balloon from $89 billion in 1996 to an estimated $529.1 billion in 2003. While imports grew faster in each of these years, in certain years the gaps between the two were especially huge. For example, real imports grew by about 12.0% in 1998, but real exports advanced by a little over 2.0%. Interestingly, real imports did shrink slightly in 2001. However, real exports declined twice as fast in that same year. The strong exports are the result of America's economic health relative to other major economies over this period. The U.S. was the engine of economic growth during this time, so it naturally served as a magnet for imports. Reinforcing this was the strong dollar, which hurt the competitiveness of U.S. products. However, the dollar has begun to weaken against other currencies, and this bodes well for real exports. Real exports should also be helped by the anticipated health of foreign economies. For example, in this hemisphere economic growth in Canada, Mexico, and South America have all lagged the U.S. However, both Mexico's (3.5%) and Canada's (3.3%) economies are expected to grow virtually as fast annually as the United State's economy (3.4%) from 2005 to 2008. South America is forecast to grow at a slightly faster 3.9% rate. Asia, excluding Japan, should be the growth champion during this same period; it is estimated to increase 5.9% per year. The Eurozone is estimated to advance 2.2% annually, while Japan should rise 1.7% per year. Real net exports are forecast to be -$529.1 billion in 2003, -$542.1 billion in 2004, -$516.7 billion in 2005, -$480.8 billion in 2006, -$471.6 billion in 2007, and -$439.0 billion in 2008.



Employment: Finally, there is good news to report about the nation's employment situation. The long string of disappointing monthly labor data was broken last summer. In its November 2003 press release, the U.S. Department of Labor reported the U.S. seasonally adjusted unemployment rate had declined to 6.0% in October 2003 from 6.1% the previous month. The same report also estimated the number of jobs increased 126,000 in October 2003. This was a welcomed change from the job losses that stretched back to early 2001. It is important to note revisions to past estimates showed employment may have been healthier than was originally thought. For example, it was originally reported the U.S. suffered a loss of 93,000 jobs in August 2003. However, the latest estimate shows a 35,000-net job gain for that month. Given this data, it appears the nation's job drought may have ended last summer. It should be pointed out, however, that not all sectors are enjoying growth. Most noticeably, manufacturing is still shedding jobs. Another sign the labor market is ripe for a recovery is the soaring productivity. Productivity rose a remarkable 7.0% in 2003's second quarter and an astounding 8.1% in its third quarter. Productivity typically surges during a recovery before employment restarts. This is because businesses use resources other than labor to meet growing demand. At some point, however, employers exhaust other alternatives and must add employees. The labor data confirm this is happening. U.S. nonfarm employment is expected to expand slowly over the forecast period. Initially, growth will be limited to the service sectors, as manufacturing continues to struggle. However, the manufacturing sector's problems are not terminal, and it should resume adding jobs early in 2004. On an aggregate basis, U.S. nonfarm employment is expected to rise 1.1% this year, 2.2% next year, 1.8% in 2006, and 1.8% in 2007. This sluggish job growth will cause the nation's civilian unemployment rate to improve marginally over the forecast period. Specifically, it will decline from 6.0% in 2003 to 5.7% in 2007.